

IT 02-14

Tax Type: Income Tax

Issue: Responsible Corporate Officer – Failure to File or Pay Tax

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
COUNTY OF COOK**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

**JOHN DOE, responsible officer
of ABC Staffing, Inc. & XYZ Staffing
Services, Inc.,
Taxpayer**

**No. 01-IT-0000
SSN: 000-00-0000
FEIN: 00-0000000
Notices of Deficiency Nos.
0000, 0000**

**Charles E. McClellan
Administrative Law Judge**

ORDER ON CROSS-MOTIONS FOR SUMMARY JUDGMENT

Background

This matter comes to be heard pursuant to a protest to two Notices of Deficiency issued to John Doe (“taxpayer” or “Doe”). Notice of Deficiency No. 0000 was issued on January 5, 2000 pursuant to Section 904(c) for the penalty provided by Section 1002(d) of the Illinois Income Tax Act¹ for the unpaid withholding tax liability of ABC Staffing (“ABC”), Inc. The unpaid taxes were for all four calendar quarters of 1996, the first and second quarters of 1997, and the second quarter of 1999. Notice of Deficiency No. 0000 also was issued on January 5, 2000 for the same penalty with respect to the unpaid withholding tax of XYZ Staffing Services, Inc. (“XYZ”) for all four quarters of 1996.

¹ Unless otherwise noted, all statutory references are to 35 ILCS 5/101, *et seq.*, the Illinois Income Tax Act (“ITA” or the “Act”).

Section 1002(d) of the Act provides for a penalty of 100% of unpaid withholding tax to be assessed against a person who is responsible for collecting and paying over to the Department employee withholding taxes and who willfully fails to do so. During the periods at issue, Doe was the president of the two corporations referred to in the Notices of Deficiency.

Doe filed a motion for summary judgment on April 5, 2002. The Department filed its cross-motion for summary judgment and reply on May 9, 2002. The Department attached to its cross-motion documents that it had failed to disclose to Doe during the discovery period, as a consequence of which Doe filed a motion for sanctions. Included in Doe's motion was a request for leave to file an amended cross-motion for summary judgment. That request was granted.

Doe filed his amended motion for summary judgment on August 22, 2002. The Department filed an amendment to its cross-motion for summary judgment on September 9, 2002 in which it continued to rely on its original filing. Doe filed his reply on September 23, 2002.

I recommend that the taxpayer's amended motion be granted and that the Department's cross-motion be denied.

Factual Assertions

1. XYZ was an Illinois corporation registered to do business in Illinois since April 27, 1994. Tp. Ex. No. 1, ¶ 2.²; Dept. Ex. No. 5.

² Citations to the affidavits and exhibits attached to the taxpayer's amended motion for summary judgment will be identified as "Tp. Ex. No. n, ¶ n." Department exhibits will be identified as "Dept. Ex. No. n."

2. Smith, the sole shareholder of XYZ, designated Doe as president of XYZ, and himself as the secretary and treasurer of the corporation. Tp. Ex. No.1, ¶ 3; Dept. Ex. No. 5.
3. ABC was an Illinois corporation registered to do business in Illinois since. February 26, 1996. Tp. Ex. No. 1, ¶ 4; Dept. Ex. No. 4.
4. Doe and Smith each owned 50% of the common stock of ABC. Tp. Ex. No. 1, ¶ 5.
5. Doe was president and Smith the secretary and treasurer of ABC. *Id.*
6. Both XYZ and ABC were engaged in the business of temporary staffing and employee leasing. Tp. Ex. No.1 ¶ 7.
7. XYZ employed the individuals that operated the business, and ABC employed the individuals that were leased to or hired temporarily by third parties. *Id.*
8. Doe, who held baccalaureate degrees in psychology and education and did some graduate work in business courses, had a background in sales, and was responsible for sales, marketing, and customer service. Tp. Ex. No. 1, ¶¶ 8, 9; Dept. Ex. No. 10, pp.10-13, 25-26.
9. Smith, who represented himself as having a finance degree and experience as a treasurer and chief executive officer, was responsible for all internal operations of the two companies, including all operations having to do with books, records, and the preparation and filing of federal and state tax returns and paying all tax obligations. Tp. Ex. No. 1, ¶¶ 10-12; Dept. Ex. No.10, pp. 25-26.
10. Doe and Smith were authorized signatories on business checking account number 5200473969 maintained by ABC at the Bank. Dept. Ex. No. 6.

11. Smith and Doe were authorized signatories on business checking account number XXXXXX maintained by XYZ at the Bank. Dept. Ex. Nos. 6, 7, 10 at pp. 56, 127-128.
12. Doe's signature was affixed to payroll checks for XYZ and ABC by using facsimile signature stamps that Smith kept in his desk drawer. Dept. Ex. No. 10, pp. 63, 89-93, 144.
13. Doe personally wrote checks on the operational account to reimburse petty cash, to reimburse himself for business expenses, and occasionally for other things when Smith was not around, but never wrote checks for anything major and he never wrote payroll checks. Dept. Ex. No. 10, pp. 57-60, 128-129.
14. From 1996 through the third quarter of 1999, XYZ and ABC employed the accounting firm of Acct. & Acct.. Tp. Ex. No. 1, ¶ 13.
15. During the audit periods Doe and Smith had regular meetings, some of which were attended by the companies' accountant, during which the business and financial affairs of the companies would be discussed. During these meetings, Doe would report on sales, sales forecasts, and client contacts. Tp. Ex. No. 1, ¶¶ 15, 16; Dept. Ex. No. 10, p. 31.
16. During these meetings, Doe would review the companies' financial statements and inquire of Smith as to the financial condition of the businesses. Smith left him with the impression that the businesses were doing well. Tp. Ex. No. 1, ¶ 17; Dept. Ex. No. 10, pp. 31-34.
17. The accounting system employed by the two companies contained a "voucher system" that would indicate that a bill had been paid when a voucher was prepared, so that when vouchers were issued for payment of the taxes, the payroll and financial

records indicated that the taxes had been paid. Tp. Ex. No. 1, ¶ 35; Dept. Ex. No. 10, p. 52.

18. Jane Doe (“Jane Doe”) was employed by ABC during the audit periods as its payroll-processing supervisor. Tp. Ex. No. 2.³

19. Jane Doe’s duties included preparation of payroll tax returns, preparation of deposits and vouchers authorizing payments for payroll taxes, reviewing all matters concerning preparation of paychecks, withholding for taxes and withholding for various other deductions. *Id.*

20. A computer system called “Pay Plus” was utilized by the companies to process the payrolls. Tp. Ex. No. 2; Dept. Ex. No. 10, pp. 51-52, 72.

21. Jane Doe prepared certain documents regarding the IL-941 forms and vouchers which she gave to Smith, her immediate supervisor, to issue the payroll tax deposit checks. *Id.*

22. Smith kept the financial records for XYZ and ABC in his office and in his home. Dept. Ex. No. 10, pp. 79-80, 141.

23. Smith was responsible for the preparation of state and federal withholding tax returns, and for signing the IL-941 returns. Tp. Ex. Nos. 1 & 4; Dept. Ex. No. 10, p. 71.

24. Doe never reviewed the bank statements or cancelled checks for either XYZ or ABC except that when he looked at the checkbook, he could see that vouchers had been prepared and checks payable to the federal or state agencies had been ripped out of the checkbook. Dept. Ex. No. 10, pp. 75-78, 93, 137-138, 140.

³ Jane Doe’s testimony is provided by affidavit marked Tp. Ex. No. 2.

25. Doe first learned of the non-filing and non-payment of the withholding taxes in January of 1998 when the BCI investigators commenced their investigation of XYZ and ABC. Tp. Ex. No. 1, ¶ 40-43; Dept. Ex. No. 10, pp. 82, 87.

Analysis

Because of the matters raised in the Department's amendment, it is necessary to address it prior to addressing the substance of Doe's amended motion for summary judgment and the Department's cross-motion.

This case originated with criminal investigations by the Department's Bureau of Criminal Investigation ("BCI"). The investigation involved both entities referred to in the Notices of Deficiency issued in this matter. At the conclusion of the BCI investigations, the Department's investigator prepared his reports. Taxpayer obtained copies of the BCI investigator's reports during the discovery process and he also deposed the Department's investigator.⁴ Taxpayer relies on the reports and the investigator's deposition testimony in its amended motion for summary judgment.

The Department claims that the BCI reports are inadmissible because they are hearsay. However, these reports are documents prepared by employees of the Department in the normal course of business that were authenticated during the course of the BCI investigator's deposition. Discovery depositions can be used for any purpose for which an affidavit can be used. Supreme Court Rule 212.

Hearsay consists of out of court statements made by an out of court declarant offered for the truth of the matter asserted. The purpose of the rule excluding hearsay

⁴ Excerpts from the transcript of the investigator's deposition are attached to taxpayer's amended motion for summary judgment marked as Exhibit 3. A complete copy of the transcript is attached to taxpayer's reply to the Department's response to taxpayer's amended motion for summary judgment marked as Exhibit 1.

evidence is that it is not subject to cross-examination. The essential element of the rule is whether the author of the statement is available to be cross-examined concerning the truth or accuracy of what was said or written. *People v. Ramos*, 112 Ill.App.2d 330, 250 N.E.2d 826(2d Dist. 1969). These reports were prepared by an employee of the Department that was deposed by taxpayer's counsel in this matter. The Department's counsel could have cross-examined the BCI investigator on that occasion if it doubted the truthfulness or accuracy of the BCI reports. Alternatively, the Department could have had the BCI investigator sign an affidavit attesting to the inaccuracy of his report if the Department felt that it was inaccurate or not truthful. Accordingly, taxpayer's reliance on these reports does not run afoul of the purpose for the hearsay rule. Therefore, the Department's hearsay objections are not persuasive.

Furthermore, it is not clear from the Department's objections, what specifically is in the investigator's reports that it considers to be hearsay. In the BCI investigator's report, the investigator recorded Smith's responses to his questions. The objection may relate to the investigator's report of his interrogation of Edward Smith, Jr. ("Smith"). Smith was the secretary and treasurer of ABC and XYZ during the audit periods. However, to the extent that Smith's answers are relevant to this matter, they are statements against his interests and that brings them within an exception to the hearsay rule. *Burton v. Drake's Mayors Row Restaurant*, 53 Ill App.3d 348, 368 N.E.2d 771. (1st Dist. 1977).

The Department also argues that the BCI reports are not admissible because they are reports of criminal investigations, and, as such, they are barred by statute, citing 735

ILCS 5/115-5(c)(2).⁵ Presumably, the Department is referring to 725 ILCS 5/115-5(c)(2). However, that section of the statute is in the Code of Criminal Procedure applicable to criminal prosecutions. This matter is not a criminal prosecution, so the provision does not apply to this matter, and the Department failed to provide any basis for applying a criminal statutory provision to these civil proceedings.

Next, the Department asks that certain averments made in Doe's affidavit that supports his motion for summary judgment be stricken on the grounds that they are not based on his personal knowledge and that they are hearsay and legal conclusions. A close reading of Doe's affidavit indicates that the statements objected to by the Department for the most part are statements made from his own knowledge regarding events that took place during the periods at issue, and, therefore, they are not hearsay. To the extent, if any, that there are legal conclusions in the affidavit, they are not material. For these reasons, the Department's request to strike is denied.

The issue in this matter that is raised in both motions for summary judgment is whether Doe was a person responsible for reporting and paying the withholding tax collected from the wages of XYZ and ABC employees, and, if so, whether he willfully failed to do so.

Summary Judgment is a drastic means of disposing of litigation and therefore should be allowed only when the right of the moving party is clear and free from doubt. *Purtill v. Hess*, 111 Ill.2d 229, 489 N.E.2d 867 (1986). In determining the existence of a genuine issue of material fact courts must consider the pleadings, depositions, admissions, exhibits, and affidavits on file and they must be strictly construed against the

⁵ There is no 735 ILCS 5/115-5(c)(2).

movant and in favor of the non-movant. *Id.* If the movant supplies facts which, if not contradicted, would entitle the movant to judgment as a matter of law, the opposing party cannot rely on his pleadings alone to raise issues of material fact. *Id.* Therefore, facts contained in an affidavit in support of a motion for summary judgment which are not contradicted by counter-affidavit are admitted and must be taken as true for purposes of the summary judgment motion. *Id.*

Doe's motion is supported by his affidavit, the affidavit of Jane Doe who was employed by ABC as the payroll-processing supervisor during the audit periods, and other documents, including a copy of the transcript of the deposition of James Conlon, the BCI special agent supervisor involved in the investigation of XYZ and ABC, copies of the activity reports of the BCI investigations of XYZ and ABC prepared by the BCI investigator and the BCI supervisor, copies of the IL-941 quarterly withholding tax returns and the IL-W-3 annual withholding tax forms for XYZ and ABC for 1996, all signed by Smith.

The Department did not support its motion with counter-affidavits or other documents sufficient to contradict the factual assertions in the affidavits of Doe and Jane Doe. Therefore, the factual assertions in Doe's affidavit must be taken as true for purposes of these motions.

The statutory provision of the Act that imposes the penalty at issue in this case, in relevant part, provides as follows:

Any person required to collect, truthfully account for, and pay over the tax imposed by this Act who willfully fails to collect such tax or truthfully account for and pay over such tax or willfully attempts in any manner to evade or defeat the tax or the payment thereof, shall, in addition to other penalties provided by law, be liable for the penalty imposed by Section 3-7 of the Uniform Penalty and Interest Act.

35 ILCS 5/1002(d).

Section 3-7 of the Uniform Penalty and Interest Act, in relevant part, provides as follows:

Any officer or employee of any taxpayer subject to the provisions of a tax Act administered by the Department who has the control, supervision or responsibility of filing returns and making payment of the amount of any trust tax imposed in accordance with that Act and who willfully fails to file the return or make the payment to the Department or willfully attempts in any other manner to evade or defeat the tax shall be personally liable for a penalty equal to the total amount of tax unpaid by the taxpayer including interest and penalties thereon.

35 ILCS 735/3-7.

Doe was an officer of XYZ and ABC, so the issue is whether he was responsible for reporting and paying the withholding taxes of ABC and XYZ and, if he was, whether he willfully failed to do so. Although Doe was the president of XYZ and ABC, being a corporate officer does not, *per se*, impose the duty to collect, account for and pay over the withheld taxes. *Monday v. U.S.*, 421 F.2d 1210, (7th Cir. 1970). However, an officer may have that duty even though he does not have the treasury function. *Id.* He has the duty if he has general control over corporate business affairs and participates in decisions concerning payment of creditors. *Id.*

This case involves two closely held corporations. Smith was the sole shareholder of XYZ and the owner of 50% of the stock of ABC. Doe owned the other 50% of ABC, but he had no equity interest in XYZ. He was the president of both corporations, but the only indication in the record of his duties and responsibilities are the statements in his deposition and affidavit that because of his background in sales, he was responsible for sales marketing and customer service. His deposition and affidavit also state that Smith

was the secretary and treasurer of both corporations and that he was responsible for all internal operations of the two corporations, including all operations having to do with books, records and the preparation of tax returns.

These averments are corroborated by the statements made by Smith to the Department's BCI investigator. Specifically, Smith told the investigator that he was responsible for the accounting, the preparation of withholding and corporate income tax returns, and for the payroll of the businesses. He also stated that he was responsible for preparation of the IL-941 forms.⁶

The Department argues that Doe was a responsible officer who willfully failed to make withholding tax payments to the Department. The Department correctly states that by introducing the NODs into evidence its *prima facie* case was established. Once the *prima facie* case has been established, the burden of proof is on the taxpayer to disprove the necessary elements. *Branson v. Dept. of Revenue*, 168 Ill.2d 247 (1995). Doe stated in his affidavit that Smith was responsible for paying the withholding taxes and for filing the tax returns. Smith corroborated that statement in his answers to the BCI investigator's questions. The key to liability in this type of case is control of the finances. *Haffa v. U.S.*, 516 F.2d 931, 936 (holding that the key to liability is control of finances within the employer corporation and the power to control the decision-making process by which the employer corporation allocates funds to other creditors.) The Department failed to introduce any evidence indicating that Doe had anything to do with deciding which creditors would be paid. The record in this case establishes that the power to control the

⁶ In January of 1998, during the course of the BCI investigation, IL W-3 and IL-941 forms for the periods at issue, all signed by Smith, were presented to the BCI investigator by Smith's attorney. Tp. Exs. No. 9, 10.

decision-making process by which the employer corporation allocates funds to other creditors resided solely with Smith.

Next the Department argues that Doe is personally liable for willfully failing to pay the XYZ and ABC withholding taxes to the Department. In support of its argument, the Department relies on the fact that Doe was president of the two companies, and a 50% shareholder of ABC, that signature stamps with his signature were used to sign payroll and other checks. These allegations are based on Doe's discovery deposition taken on January 3, 2002. Dept. Ex. No. 10 pp. 63, 91-92, 144. What the Department did not include in this allegation is that Doe stated that the stamps were kept in Smith's desk and used by Smith and Jane Doe and that he never used them and had no control over them. *Tp. Ex. No.* pp. 90-94, 144-145. The Department offered no evidence to controvert this testimony. There is no evidence in the record that Doe chose to pay creditors other than the Department. His uncontroverted statement was that he occasionally signed checks when Smith was absent. Other than that he only signed checks to reimburse the petty cash fund and occasionally to himself for business expenses he incurred, and there is no evidence that he wrote these checks during the periods when the withholding taxes were delinquent. There is nothing in the record to indicate that he knew the withholding taxes had not been paid when he signed any checks.

The Department produced no evidence to contradict the assertions that Smith, and not Doe, was responsible for preparing, filing and paying the withholding tax. There is no evidence in the record that establishes that Doe had general control over corporate business affairs or that he had anything to do with deciding what creditors would be paid.

Therefore, the record shows that Doe was not responsible for filing the IL-941 forms and for paying the withholding tax to the Department.

However, even if Doe was a responsible person, there is no evidence to establish that he willfully failed to report and pay the withholding tax. The statute does not define the concept of willful failure. However, in applying the penalty tax, the Illinois courts look to federal cases involving § 6672 of the Internal Revenue Code, 26 U.S.C. §6672, which contains language similar to the Illinois statute. *Branson v. Dept. of Revenue*, *supra*. *Dept of Revenue v. Joseph Bublick & Sons*, 68 Ill.2d 568 (1977). The key to liability under IRC § 6672 is control of finances within the employer corporation including the power to control the allocation of funds to other `creditors in preference to the withholding tax obligations. *Haffa v. U.S.*, 516 F.2d 931 (7th Cir. 1975). The issue of willfulness is concerned with the state of the responsible person's state of mind. *Sawyer v. U.S.*, 831 F.2d 755 (7th Cir. 1987) "Willful failure to pay taxes has generally been defined as involving intentional, knowing and voluntary acts or, alternatively, reckless disregard for obvious or known risks." *Branson*, 168 Ill.2d at 255.

Doe stated in his affidavit that he first knew about the fact that there was a problem with state taxes when the BCI investigation commenced in January 1998. During his deposition, he stated that Smith kept the books and records in his office and at his home. He stated that he saw the checkbook from time to time and noted that vouchers had been prepared for the withholding taxes and the checks had been removed indicating that they were written for payment. The cash disbursement journal (Tp. Ex. No. 8) supports this statement because it shows entries for checks prepared to pay the Illinois withholding taxes. Although these checks were prepared, they were not issued. However,

the fact that they were not issued is not evident from the examination of the checkbook. Thus, there is nothing in the record to indicate that Doe should have known that the withholding taxes were not being paid or that he recklessly disregarded any obvious or known risk that the withholding taxes were not being paid.

For the reasons stated above, I recommend that the taxpayer's amended motion for summary judgment be granted and the Department's cross-motion denied. I also recommend that the NODs be cancelled.

Date: 11/21/2002

Charles E. McClellan
Administrative Law Judge